UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

THE LEAST DEVELOPED COUNTRIES REPORT 2006

OVERVIEW

by the Secretary-General of UNCTAD

UNITED NATIONS

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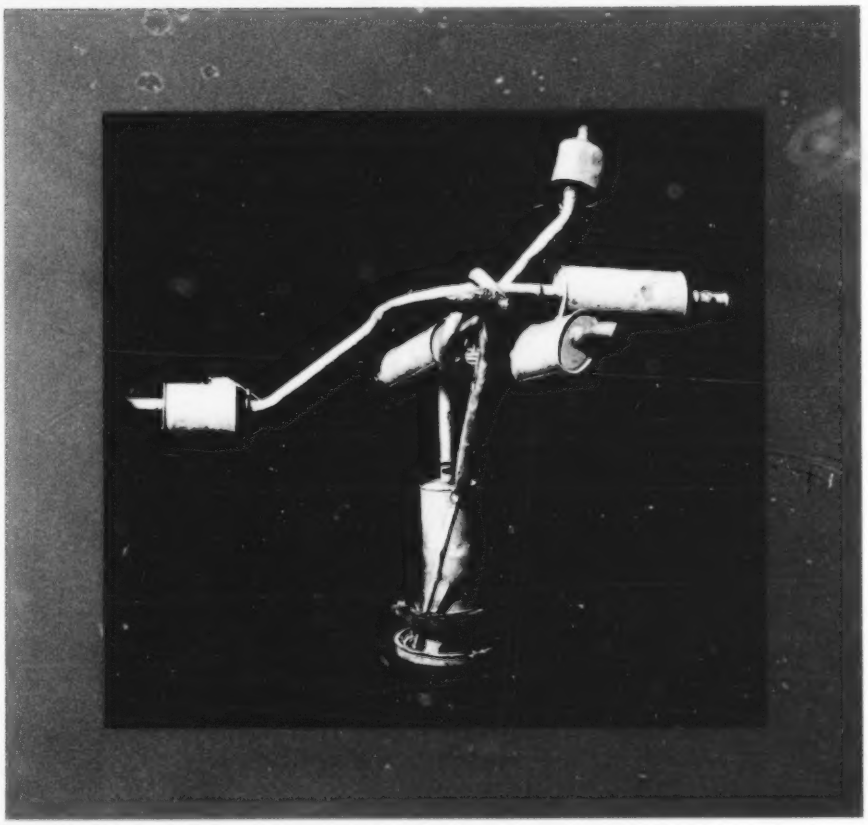

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
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Overview

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Overview

This Report is intended as a resource for policymakers in the least developed countries (LDCs) and for their development partners. Part I focuses on recent economic trends in the LDCs and the progress that those countries are making towards achieving the quantitative development targets of the Programme of Action for the Least Developed Countries for the Decade 2001–2010 (POA), agreed at the Third United Nations Conference on the LDCs (UNLDC III) held in Brussels in 2001. Part II focuses on the issue of developing productive capacities in the LDCs. The Overview summarizes the basic policy argument in a nutshell for the busy reader, and then the basic evidence upon which this argument is founded.

THE POLICY ARGUMENT IN A NUTSHELL

Productive capacities matter

In recent years, many LDCs have achieved higher rates of economic growth than in the past and even higher growth of exports. But there is a widespread sense — which is apparent in the concern to ensure "pro-poor" growth — that this is not translating effectively into poverty reduction and improved human well-being. Moreover, the sustainability of the accelerated growth is fragile as it is highly dependent on commodity prices, including oil prices, trends in external finance, preferences for exports of manufactured goods, and climatic and weather conditions. In the late 1970s and 1980s, many LDCs experienced growth collapses in which gains from earlier growth spurts were reversed, and the vulnerability to this happening again remains.

Developing productive capacities is the key to achieving sustained economic growth in the LDCs. It is through developing their productive capacities that the LDCs will be able to rely increasingly on domestic resource mobilization to finance their economic growth, to reduce aid

dependence and to attract private capital inflows of a type that can support their development process. It is also through developing their productive capacities that the LDCs will be able to compete in international markets in goods and services which go beyond primary commodities and which are not dependent on special market access preferences.

Developing productive capacities is also the key to reducing pervasive poverty in the LDCs. Although aid transfers to the LDCs are increasingly being used to alleviate human suffering, substantial and sustained poverty reduction cannot be achieved with such expressions of international solidarity alone. It requires wealth creation in the LDCs and the development of domestic productive capacities in a way in which productive employment opportunities expand.

The development of productive capacities will be particularly important during the next 15 years because the LDCs are at a critical moment of transition in which they face a double challenge. Firstly, more and more people are seeking work outside agriculture and urbanization is accelerating. For the LDCs as a group, the decade 2000–2010 is going to be the first decade in which the growth of the economically active population outside agriculture is predicted to be greater than the growth of the economically active population within agriculture. This transition will affect more than half the LDCs during the decade and even more in the decade 2010–2020. Secondly, the LDCs must manage this transition in an open-economy context. As shown in earlier LDC Reports, very few LDCs have restrictive trade regimes at the present time and most have undertaken rapid and extensive trade liberalization. But their existing production and trade structures offer very limited opportunities in a rapidly globalizing world driven by new knowledge-intensive products with demanding conditions of market entry. At the same time, rapid opening up in more traditional sectors is exposing existing producers to an unprecedented degree of global competition. Benefiting from recent technological advances requires advancing towards and crossing various thresholds in human capital, R&D and management practice, which most LDC economies have lacked the resources to do. The relentless logic of cumulative causation threatens to push LDCs even further behind.

If productive employment opportunities do not expand sufficiently for the growing labour force in the LDCs — in non-agricultural activities as well as within agriculture — there will be increasing pressures for international migration from the LDCs and high levels of extreme poverty will persist. The development of productive capacities is also necessary to secure the fiscal basis for good governance and to ensure effective sovereignty. Without the development of their productive capacities, more and more LDCs will face recurrent, complex humanitarian emergencies.

Productive capacities should be at the heart of development and poverty reduction policies

It is becoming widely accepted that the developing world needs not just lower tariffs or improved market entry, but also enhanced supply capacities in order to benefit from the open, global economy through producing and trading competitive goods and services. New international initiatives under discussion, such as "aid for trade", recognize that without productive capacities there will be little to trade and that these capacities will not emerge automatically from the workings of market forces alone, but from the interplay of entrepreneurship, public policy and international action. To the extent that the "aid for trade" initiative results in increased aid for, inter alia, export supply capacities, this is a move in the right direction.

However, in general, national and international policies do not adequately address the challenge of developing productive capacities in the LDCs. There is a need for a paradigm shift which places the development of productive capacities at the heart of national and international policies to promote development and poverty reduction in the LDCs.

Productive capacities are defined in this Report as *the productive resources, entrepreneurial capabilities and production linkages which together determine the capacity of a country to produce goods and services and enable it to grow and develop.* For tradable goods and services, what matters is the capacity to produce in an internationally competitive

manner. Productive capacities develop within a country through three closely interrelated processes: capital accumulation, technological progress and structural change. Capital accumulation is the process of maintaining and increasing stocks of natural, human and physical capital through *investment*. Achieving technological progress is the process of introducing new goods and services, new or improved methods, equipment or skills to produce goods and services, and new and improved forms of organizing production through *innovation*. Structural change is the change in the inter- and intrasectoral composition of production, the pattern of inter- and intrasectoral linkages and the pattern of linkages amongst enterprises. Such change often occurs through investment and innovation, and the emerging production structure in turn influences the potential for further investment and innovation.

To put productive capacities at the heart of development and poverty reduction policies means to focus on promoting capital accumulation, technological progress and structural change in the LDCs. National and international policies should seek to start and to sustain a virtuous circle in which the development of productive capacities and the growth of demand mutually reinforce each other. This should be done in a way in which productive employment opportunities expand in order to ensure poverty reduction.

Developing productive capacities requires new policy orientations

This paradigm shift is not something totally new. But it would be a new policy orientation for the LDCs and their development partners, even though developing productive capacities is part and parcel of the Brussels Programme of Action for the LDCs. It would entail a production- and employment-oriented approach to poverty reduction which would encompass, rather than be narrowly focused on, increasing social sector spending and achieving human development targets. It would also entail a development-driven approach to trade rather than a trade-driven approach to development. An approach to developing productive capacities which is simply trade-centric will not be sufficient for sustained and inclusive growth in the LDCs.

The paradigm shift would also strengthen current efforts to develop productive capacities in the LDCs — such as in policies to improve their investment climate — through:

- Macroeconomic policies oriented to promoting growth, investment and employment;
- A multi-level approach which not only seeks to set the framework institutions and macroeconomic environment, but also includes policies to change meso-level production structures and institutions, as well as micro-level capabilities and incentives;
- An active approach to promoting entrepreneurship;
- A strategic approach to global integration in which the speed and degree of liberalization in different economic spheres take account of the goal of developing productive capacities.

National and international policies to develop productive capacities in the LDCs should prioritize the relaxing of key constraints on capital accumulation, technological progress and structural change. The identification of key constraints needs to be done on a country-by-country basis. However, one consequence of the combination of a deficiency of domestic demand on the one hand, and of weak capabilities, infrastructure and institutions for being internationally competitive on the other hand, is that productive resources and entrepreneurial capabilities are underutilized within the LDCs owing to lack of demand and structural weaknesses. There is surplus labour, latent entrepreneurship, untapped traditional knowledge, a vent-for-surplus through exporting and unsurveyed natural resources. Policy thus needs to be geared to mobilizing these underutilized potentials. As Albert Hirschman has put it, "Development depends not so much on finding optimal combinations for given resources and factors of production as on calling forth and enlisting for development purposes resources and abilities that are hidden, scattered, or badly utilized".

Within the LDCs, increasing productivity and employment for long-run sustainable growth requires a twin strategy of investing in dynamically growing sectors while at the same time building capacity in sectors where the majority of labour is employed. A strategy of investing only in dyn mic

sectors in attempts to "leapfrog" may not be enough to reduce poverty, mainly because the fastest-growing sectors may often not be where the majority of the poor are employed and may require skills and training that the poor do not possess. The challenge then is to broaden the impact of the dynamically growing sectors of the economy, while deepening their linkages with other sectors in the economy — sectors where the majority of the poor are underemployed. At the same time, it is paramount to ensure that the poor can be provided with skills and training for labour absorption in these growing areas of the economy.

The most effective approach would support and stimulate simultaneous investments in agriculture, industry and services, along the value chain of the promising sectors, as well as promotion of exports including, in particular, upgrading and increased local value-added of abundant natural resources. The focus should be on triggering growth through investment and production linkages and seeking to sustain an interactive economic growth process through the dynamic interrelationship between the primary, secondary and tertiary sectors. Agricultural growth linkages, in which there is a virtuous circle in which demand stimulus from agricultural growth generates investment, entrepreneurship and employment in non-agricultural activities, particularly non-tradables, are likely to be relevant in many LDCs and at the heart of efforts to create a more inclusive process of development which supports sustainable poverty reduction.

Poverty reduction can occur rapidly if policy catalyses and sustains a virtuous circle in which the development of productive capacities and the growth of demand mutually reinforce each other, and there is a transformation of productive structures towards more skilled and technology-intensive production systems consistent with higher value-added activities and strong productivity growth. This will require the building of a virtuous circle of increased savings, investment and exports through a combination of market forces and public action. This implies mobilizing, strengthening and transforming the enterprise sector from SMEs to larger globally competitive enterprises, diversification of their export structures and establishing a dense network of linkages across firms and farms, in and between both the rural and non-rural sectors. Much of the effort will be focused on strengthening the role of domestic

enterprises. However, foreign firms (through FDI and other channels) can be a beneficial factor in this process, provided that learning economies and spillover effects prevail — and possible costs can be mitigated.

The process requires a better balance between domestic and international sources of growth. Increased exports and export diversification are an absolutely essential part of the strategy. However, an exclusive emphasis on exports rather than domestic demand, or vice versa, or on developing productive capacities in tradables rather than non-tradables, or vice versa, is likely to be counterproductive. Both matter for growth and poverty reduction. Increased domestic demand also results from increasing incomes and poverty reduction, and this builds a further feedback mechanism supporting the momentum of growth as productive employment opportunities expand.

An economic transformation process can take place only if an enabling policy framework is put in place that would bring about the process of capital accumulation, structural change and technological progress. This will require not only a re-evaluation of the current national and international policies, but also the building up of the necessary institutions, particularly the private enterprise sector (firms), and financial and knowledge systems. In addition to the need for investment and improvement of the physical infrastructure, economic agents themselves (firms) need to be created or strengthened, entrepreneurship needs to be mobilized, underutilized traditional knowledge revived and productive employment created for underutilized labour.

At the national level, there is a need for more development-oriented poverty reduction strategies, as argued in the last two Least Developed Countries Reports. These would focus on developing production capacities in a way which creates productive employment opportunities. But a good national poverty reduction cannot be fully effective in an adverse international enabling environment, and it can also be enhanced by appropriate international support measures. The scaling-up of aid is occurring and there are promises that this will continue. However, as aid inflows increase, it is important that the composition of aid shifts back towards the development of productive capacities. Increased aid for physical infrastructure — transport, telecommunications and energy — is

certainly part of this. But it is also necessary to go beyond this, and in particular, to strengthen production sectors and linkages, and also to support enterprise development and the improvement of domestic financial and knowledge systems. New international support measures which can promote the development of productive capacities in the LDCs need to be developed.

Recent economic trends and progress towards achievement of UNLDC III development targets

Recent economic trends

The average GDP growth rate in the LDCs as a group in 2004 was the highest for two decades. This was underpinned by record levels of merchandise exports and record levels of capital inflows, particularly in the form of grants and FDI. Most of the oil-exporting LDCs did particularly well, benefiting from higher oil prices in 2004 especially. But the good economic performance was not confined to those countries. Real GDP growth was 6 per cent or more in 15 LDCs in 2004, including 11 LDCs which do not export oil.

Within this overall growth performance the trend towards increasing divergence amongst the LDCs, which first emerged in the early 1990s, has continued. Real GDP per capita stagnated or declined in 2004 in 15 out of 46 LDCs for which data are available.

This divergence is partly related to the differential access to external finance. Both FDI inflows and ODA grants, the two major elements driving the surge in capital inflows, were highly concentrated. Ten LDCs absorbed 84 per cent of FDI inflows in 2004. In nominal terms, aid actually doubled between 1999 and 2004. But 30 per cent of this increase was absorbed by Afghanistan and the Democratic Republic of the Congo. For other

countries, the nominal increase in aid was much smaller. Indeed, it either stagnated or declined in real terms in almost half of the LDCs during the same period, including 9 out of the 10 island LDCs.

Another issue of concern is the sustainability of the recent economic performance. The ratio of gross domestic savings to GDP, which is already much lower than in other developing countries, actually declined from 13.4 per cent in 2003 to 11 per cent in 2004. During that period, the LDCs' reliance on external finance savings to finance capital formation increased. Many LDCs are also particularly vulnerable because they are net importers of both food and oil. The combination of price increases in these sectors can considerably worsen their persistent trade deficits. The effects of very high recent oil prices are not evident, given the years for which data are available.

The sustainability of the recent growth performance will depend in particular on the extent to which existing and additional ODA and FDI are channelled into productive investment, both private and public, and support increased domestic savings, structural change and an upgrading and diversification of productive capacities. Unfortunately, a large share of the increase in ODA is attributable to debt relief and emergency assistance, which together accounted for 35 per cent of total net ODA disbursed to LDCs in 2003 and 27 per cent disbursed in 2004. FDI inflows remain oriented towards exploiting extractive sectors. The external debt stock of the LDCs continues to increase in spite of major debt relief measures. In 2003, interest payments and profit remittances were equivalent to about 60 per cent of the value of grants received (excluding technical cooperation).

Finally, economic growth will not be sustainable unless it is a type of growth which leads to improvements in human well-being that are socially inclusive. The results of the economic growth which are now occurring are, in this regard, quite mixed (see below).

Progress towards achievement of UNLDC III development targets

The most striking feature of progress towards the achievement of the UNLDC III targets since 2001 is the much stronger engagement of development partners than in the 1990s with respect to aid, debt relief and market access. During the 1990s, many LDCs engaged in significant and far-reaching economic reforms, including extensive trade liberalization, financial liberalization and privatization. But aid fell by 45 per cent in real per capita terms between 1990 and 1998. However, as noted above, this trend has now been reversed, with aid inflows doubling in nominal terms since 1999. Important progress has also been made on debt relief for some LDCs; and these efforts to increase development finance for the LDCs have been complemented with new initiatives to move towards the objective of duty-free and quota-free access for all LDC products. There has also been significant progress in the untying of aid.

These positive trends are encouraging. However, aid inflows have still not reached the levels commensurate with the aid-to-GNI targets in the POA. Moreover, the recent surge in aid has been driven by debt forgiveness grants and emergency assistance grants, and a large proportion of the increase in aid has been concentrated in Afghanistan and the Democratic Republic of the Congo. Up to 2004, the increase in aid also reinforced the trend away economic infrastructure and production sectors towards social sectors. Despite debt relief for some, the overall debt burden of the LDCs continues to increase. Moreover, in spite of the special market access initiatives, the proportion of total developed country imports from LDCs admitted free of duty actually declined from 77 per cent to 72 per cent between 1996 and 2003 if oil and arms imports are excluded.

Economic growth and investment rates are higher than in the 1990s in many LDCs. But only 6 out of the 46 LDCs for which data are available met or exceeded the POA target of growth of 7 per cent per annum between 2001 and 2004. Ten out of 39 LDCs for which data are available met the investment target of 25 per cent of GDP during 2001–2004.

Eighteen out of the 46 LDCs for which data are available were unable to achieve per capita growth rates of more than 1.0 per cent per annum during the period 2001–2004, which is far too low to have a serious effect on the extreme poverty in which about half the population of LDCs live. Moreover, progress towards human development goals is very mixed. More progress is being made in human development dimensions that are directly affected by the quantity and quality of public services (primary education, gender equity education and access to water) than with regard to those that are the outcome of both public services and levels of household income (hunger and child mortality).

In the end, the sustainability of economic and social progress in the LDCs will ultimately depend on building up their productive base so that they can increasingly rely on domestic resource mobilization and private rather than official sources of external finance, and can compete in international markets without special market access preferences. The POA targets wisely have a wider reach than the MDGs, emphasizing the importance of developing productive capacities. However, the increased external resources being provided by development partners will not translate into sustained economic and social progress unless development finance for LDCs continues to be scaled up effectively, to be complemented with more effective trade development measures and to be linked to efforts to develop domestic productive capacities.

DEVELOPING PRODUCTIVE CAPACITIES: KEY FINDINGS AND ANALYSIS

Potential versus actual growth

The least developed countries have the potential to achieve very high rates of economic growth and to reduce poverty rapidly if constraints on the development of their productive capacities are relaxed. The Report demonstrates this with an analytical framework and empirical estimates of how fast the LDCs could grow during the period 2002–2015 if their

productive capacities were developed. The analysis indicates that the growth rate target of more than 7 per cent, which is part of the Brussels Programme of Action for the LDCs, is achievable. But it requires a fast catch-up growth scenario in which there is full employment of the labour force and various potential sources of labour productivity growth, which are available to all poor countries, are exploited. In particular, it requires structural change to enable increasing returns to scale and external economies, faster human capital accumulation, and faster acquisition and absorption of technologies already in use in other countries.

This catch-up growth scenario will not be possible without substantially increased investment rates. These must be financed from substantially increased domestic savings, or substantially increased external resource inflows, or some combination of the two. Accelerated export growth will also be necessary in order to pay for the increased imports which will be required for sustaining faster economic growth. There will also need to be an increased technological effort to acquire and utilize modern technologies in use in other countries. The full-employment output growth trajectory will not be achieved unless there are strong demand-side incentives to invest. Realizing the potential growth rates will thus be possible only if key constraints on the development of productive capacities are addressed.

As these constraints are very strong in the LDCs, the actual growth rates achieved by the LDCs have thus been much lower than these potential growth rates. Taking a long view, real GDP per capita grew at only 0.72 per cent per annum for the group of LDCs as a whole during 1980–2003. For 41 LDCs for which data are available, 17 had negative average annual GDP per capita growth rates over this period and in only 9 did the average annual GDP per capita growth rate exceed 2.15 per annum over the period, which was a rate sufficient for their income per capita to be converging with that in high-income OECD countries.

The recent improved growth performance in some LDCs noted above is certainly encouraging. However, closer analysis of the year-to-year changes which have occurred in the LDCs shows that historically many LDCs have experienced short periods of rapid growth, but these have been followed by economic crises in which there are often quite severe

output losses and economic recoveries of varying strengths and completeness. Of the 40 LDCs for which data are available, only 7 have experienced steadily sustained growth — Bangladesh, Bhutan, Burkina Faso, Cape Verde, the Lao People's Democratic Republic, Lesotho and Nepal. All the other LDCs have experienced economic contractions of varying duration and severity since achieving political independence.

Of the 33 LDCs which have experienced economic crises with major output losses, there are only 12 whose real GDP per capita is now higher than it was at its peak in the 1970s or early 1980s. These countries include a number of high-performing economies such as Mozambique and Uganda which have grown rapidly after economic collapse. The other 21 LDCs, — just over half of the countries for which data are available — have experienced growth collapses in the sense that their real GDP per capita in 2003 was lower than it had been between 20 and 30 years earlier. Eleven out of those 21 LDCs have simply not recovered at all from the growth collapse. However, amongst the other 10, there are a number of countries, such as Gambia and Rwanda, whose growth record since the mid-1990s has been good but which still have not recovered to achieve earlier levels of real GDP per capita. The recent improvement in growth performance of the LDCs as a group reflects the fact that increasing numbers are recovering.

As the catch-up growth scenario shows, the potential for rapid and sustained growth exists in the LDCs if they can develop their productive capacities. If such development does not happen, even countries which are growing faster now are likely to experience the same kind of growth collapses as characterized past LDC growth experience.

Trends in the development of productive capacities

Capital accumulation

Despite improvements in the 1990s, capital formation was still only 22 per cent of GDP in the LDCs as a group in 1999–2003 and domestic

private investment was particularly weak. Capital formation in the LDCs is far below the rate which is estimated to be required for the fast catch-up growth scenario discussed above (35 per cent of GDP) and also below that required for a slow catch-up scenario (28 per cent of GDP), in which technological acquisition occurs more slowly than in the fast catch-up scenario.

A further concern is that actual rates of human capital formation in the LDCs in the 1990s were slower than in other developing countries. The average number of years of schooling of the adult population in the LDCs was three years in 2000, which was less than the level in other developing countries in 1960. The brain drain is also increasing in many LDCs. In 2000, one in five of the stock of "high-skill workers" in the LDCs, defined as those with tertiary education (13 years of schooling or more), was working in an OECD country.

The inadequate rates of physical and human capital formation reflect weaknesses in domestic resource mobilization to finance capital formation, as well as weaknesses in the way in which external capital inflows are supporting domestic processes of capital accumulation. Gross domestic savings rose to 13.6 per cent of GDP in 1999–2003. But with this savings rate it is impossible, without external capital inflows, even to achieve positive rates of GDP per capita growth. Estimates of genuine savings, which take account of capital depreciation and natural resource depletion, also indicate that, without ODA grants, there were negative savings for all years between 1991 and 2003, and that the genuine savings rate, without ODA grants, was also declining. Thus, although the growth performance of the LDCs as a group improved considerably in the 1990s, their domestic productive resource base — as measured by genuine savings without ODA grants — has been shrinking.

Government revenue and expenditure are also low, particularly in countries which do not have access to mineral resource rents. During 2000–2003, government final consumption expenditure in the LDCs was equivalent to $26 per capita compared with $186 per capita in other developing countries.

External capital inflows can play an important catalytic role in kick-starting and supporting a virtuous cycle of domestic resource mobilization in which expanding profitable investment opportunities generate increased savings and increased savings in turn finance increased investment. There is a major opportunity here because since 2000 the sharp decline in ODA to LDCs which occurred during the 1990s has been reversed, and FDI inflows into LDCs, though geographically concentrated, are also increasing. But the limited evidence suggests that FDI inflows are not crowding in domestic private investment. Moreover, there are various features of the current aid regime which imply that ODA is not playing a catalytic role in boosting domestic resource mobilization and expanded domestic capital accumulation.

Particularly important is the fact that the composition of aid is oriented away from physical capital formation and productive sectors. Between 1992–1995 and 2000–2003, ODA commitments to economic infrastructure and production-oriented sectors declined from 45 per cent to 26 per cent of the total commitments of all donors to LDCs. If one focuses simply on aid commitments to production sectors (agriculture, industry, mining, construction, trade and tourism), it will be seen that this constituted only 6.8 per cent of total aid commitments in the period 2000–2003. ODA commitments to banking and financial services were only 1 per cent of total aid commitments in 2000–2003.

Structural change

For the LDCs as a group there has been little structural change since the early 1980s, though there are significant differences between LDCs. The share of agriculture in GDP in the LDCs is declining slowly (from 37 per cent in 1980–1983 to 33 per cent in 2000–2003). Both industrial and service activities are expanding (in rounded numbers, from 23 per cent to 26 per cent of GDP and from 39 per cent to 42 per cent of GDP respectively over the same period). But much of the increase in industrial value-added is concentrated in a few LDCs and the types of industrial activities which are expanding most in the LDCs are mining industries, the exploitation of crude oil and the generation of hydroelectric power rather than manufacturing. Moreover, the types of services which are expanding

most are low value-added and survivalist petty trade and commercial services.

Whilst the LDC group as a whole has seen a relatively modest increase in manufacturing value-added, there is considerable unevenness in this process. Between 1990–1993 and 2000–2003, half of the total increase in manufacturing value-added in the LDC group as a whole was attributable to the growth of manufacturing in Bangladesh. Many of the LDCs individually have seen a considerable contraction of manufacturing value-added. Between 1990–1993 and 2000–2003 manufacturing value-added as a share of total value added declined in 19 out of 36 LDCs for which data are available and stagnated in two. Between 1990 and 2000, moreover, a total of 14 out of 25 LDCs saw a decline in their share of medium- and high-technology manufactures in total manufactures.

Labour productivity

The evidence shows that, on average, it required 5 workers in the LDCs to produce what one worker produces in other developing countries, and 94 LDC workers to produce what one worker produces in developed countries in 2002–2003. Worse still, the productivity gap is widening. Labour productivity in the LDCs as a group in 2000–2003 was just 12 per cent higher than in 1980–1983, whilst it increased by 55 per cent on average in other developing countries. Significantly, although agricultural value-added per agricultural worker rose slightly in the LDCs, non-agricultural value-added per non-agricultural worker actually declined by 9 per cent between 1980–1983 and 2000–2003. Non-agricultural labour productivity declined in four fifths of the LDCs for which data are available over this period, a fact which indicates that there is a widespread and major problem in productively absorbing labour outside agriculture.

Trade integration

The goods and services which the LDCs can supply competitively to world markets are ultimately limited by the goods and services which they

can produce and how efficient they are in producing them. This is the basic source of the marginalization of the LDCs in world trade. Even if the LDCs exported all their output, their share of world exports of goods and services would be only 2.4 per cent, even though their share of the world population is over 10 per cent.

Moreover, just as the production structure of the LDCs is strongly oriented to exploiting natural resources, so their export structure is also strongly oriented in that way. Primary commodities contributed about two thirds of total merchandise exports in 2000–2003. An important feature of the trends in the merchandise export composition of the LDCs is that manufactures exports have been increasing. In 1980–1983, manufactured exports constituted only 13 per cent of total merchandise exports for the LDCs as a group and now they constitute about one third. However, the shift away from primary commodities into manufactures is occurring much more slowly than in other developing countries and has not gone as far. It is concentrated in low-skill labour-intensive products, particularly garments, which have often developed to take account of special preferences and are now vulnerable with the end of the Agreement on Clothing and Textiles. Export production is not well rooted in domestic systems of production and, at worst, exists as enclaves of dynamism with almost no production linkages with the rest of the economy. Medium- and high-technology manufactured goods exports accounted for less than 3 per cent of the total merchandise trade of LDCs in 2000–2003, whilst they constituted 40 per cent of the total merchandise trade of other developing countries. Moreover, the expansion of manufactured exports has also been concentrated within a few LDCs.

The data also show that there has been a very limited pattern with regard to upgrading *within* primary commodity exports. For the LDCs as a group, the share of processed minerals and metals within total mineral and metal exports fell from 35 per cent to 28 per cent between 1980–1983 and 2000–2003. The share of processed agricultural goods within total agricultural exports increased from 23 per cent in 1980–1983 to 18 per cent in 2000–2003. The main positive sign of upgrading in the composition of commodity exports has been a shift, within unprocessed agricultural products, from static to more dynamic products. If one uses an UNCTAD definition of dynamic products as those with an elasticity of

demand greater than one, it is seen that the most important dynamic products are fish and fishery products and spices.

Technological progress and the development of technological capabilities

The overall lack of structural change, the very slow rate of productivity growth and the limited range of goods in which LDCs are internationally competitive are all symptomatic of a lack of technological learning and innovation within LDCs. The patterns of production and trade indicate that the level of accumulation of knowledge-based assets is generally low. But there is also regression rather than accumulation in these assets in many LDCs.

Using traditional indicators of technological effort (such as R&D, patenting, numbers of scientists and researchers and publications), it is apparent that there is a major knowledge divide between the LDCs, other developing countries and developed countries.

- R&D expenditure in both LDCs and other developing countries is very low compared with that in OECD countries. Gross expenditure on R&D in 2003 (or the latest available year) was 0.2 per cent of GDP in the LDCs and 0.3 per cent of GDP in other developing countries, compared with 2.2 per cent of GDP in OECD countries.
- The number of researchers and scientists engaged in R&D activities per million population in the LDCs in 2003 (or the nearest year) is just 27 per cent of the level in other developing countries and 2 per cent of the level in OECD countries.
- During the period 1990–1999, only 0.1 per cent of the scientific and technical journal articles in physics, biology, chemistry, mathematics, clinical medicine, biomedical research, engineering and technology, and earth and space sciences originated in LDCs.
- Between 1991 and 2004, only 20 US patents were granted to citizens of LDCs, compared with 14,824 to citizens of other developing countries and 1.8 million to citizens of OECD countries.

It would be wrong, however, to infer that innovation and problem-solving are not occurring in the LDCs. There are many incremental innovations with significance for domestic needs that are not being captured by these traditional indicators. R&D expenditure is certainly not the only indicator. But firm-level data from Investment Climate Surveys also indicate deficiencies in technological capabilities, particularly in domestic enterprises. Investment in capital equipment is identified as the most important channel of technological acquisition by firms in these surveys. However,

- As a share of GDP, machinery and equipment imports into LDCs in the period 2000–2003 were lower than those into other developing countries (3 per cent versus 4.8 per cent of GDP), and the gap between the two groups of countries has widened since the early 1980s.
- In real per capita terms, machinery and equipment imports into LDCs during 2000–2003 were at almost the same level as in 1980. Real capital goods imports per capita were about $10 per capita (in 1990 dollars), which was seven times lower than real capital goods imports of other developing countries

The basic weakness of human resources within the LDCs, indicated by the general statistics on years of schooling and the brain drain given above, makes the social basis for building technological capabilities very weak. This is also apparent in technically-related education. In 2001, technical and vocational education constituted only 2.6 per cent of total secondary enrolment in the LDCs on average, as against 10.4 per cent in developing countries and 25 per cent in OECD countries. Enrolment in tertiary technical subjects is very low, mainly because enrolment in tertiary education in the LDCs in general is much lower than in other developing countries and OECD countries. In recent years, tertiary enrolment was equivalent to only 6 per cent of the population aged 20–24 in LDCs, compared with 23 per cent in other developing countries and 57 per cent in high-income OECD countries. Within tertiary enrolment, the share of enrolments in science and agriculture in LDCs is at approximately the same levels as in other developing countries and OECD countries. But the share of engineering enrolments within tertiary enrolment is just over half the level in other developing countries. Tertiary-level enrolments, particularly in technical subjects, are important for developing the

managerial and technical skills to use modern technologies efficiently and to adapt imported technologies to local conditions. This indicates a major gap in the general competences which provide the basis for technological capabilities.

Differences amongst the LDCs

Given the diversity in the growth performance of the LDCs, the Report identifies trends in the development of productive capacities in three groups of LDCs divided into three groups: converging economies, which are defined as those which achieved an average growth of real GDP per capita of more than 2.15 per annum during the period 1980–2003; weak-growth economies, which are those that did not achieve this level but had positive growth of real GDP per capita over the period; and regressing economies, in which real GDP per capita was declining over the period.

Analysis of the differences amongst the economies in terms of physical capital formation and its financing shows significant differences. At the start of the 1980s, there was not that much difference in the investment rates in the three groups of countries. But by 1999–2003, the ratio of gross capital formation to GDP had increased by 12 percentage points on average in the converging economies and by 6 percentage points in the weak-growth economies, and had declined in the regressing economies. It is clear that increased investment is associated with higher and more sustained growth rates. In the converging economies, the increased investment was also associated with rising domestic savings. This also occurs in the weak-growth economies. But the rise in investment is particularly related to increases in FDI inflows which occurred after 1993. On average, three-quarters of the increase in the rate of capital formation in the weak-growth economies can be attributed to increased FDI inflows. With regard to grants, it is clear that during the 1980s grants as a share of GDP increased significantly in the converging economies, but subsequently decreased. In contrast, grants are increasing as a share of GDP in both the weak-growth and the regressing economies.

There are also major differences between the three groups of economies in terms of patterns of structural change, productivity growth and trade integration. Again focusing on the difference between the converging economies and regressing economies, it is apparent that the converging economies are characterized by (i) a decline in the share of agriculture in GDP; (ii) an increase in manufacturing value-added; (iii) rising labour productivity in both agriculture and non-agricultural sectors; (iv) an increase in the share of trade in GDP; and (v) an increase in the share of manufactures exports in merchandise exports. In the regressing economies (i) the share of agriculture in GDP is rising; (ii) de-industrialization, in the sense of a declining share of manufactures in GDP, is occurring; (iii) labour productivity is declining in both agriculture and non-agriculture; (iv) trade is declining as a share of GDP; and (v) although manufactures exports are increasing as a share of total merchandise exports, this is occurring much more slowly than in the converging economies.

From these patterns, it is clear that the dynamics of production structures matter for economic growth in the LDCs. Just as within other developing countries, industrialization, and in particular the expansion of manufacturing activities, is characteristic of the LDCs which have experienced the highest and most sustained economic growth. Moreover, de-industrialization, understood here as a decline in the share of manufacturing activities in GDP, and also an increase in the share of agriculture in GDP, are characteristic features of economic regression. The successful LDC experience does not diverge from the classic long-term patterns of structural transformation which have been found when sustained economic growth occurs.

The patterns of structural change, productivity growth and trade integration within the converging economies are indicative of much greater technological progress than in the weak-growth and regressing economies. However, data for trends in machinery and equipment imports do not indicate significant differences between the country groups. This is related to the fact that the level of such imports is associated with FDI inflows. However, it suggests that the development of technological capabilities may be an area of weakness even in converging economies, and that their growth processes remain vulnerable.

The problem of productive absorption of labour

In almost all the LDCs there is an imbalance between the rate of growth of the labour force, which is very rapid owing to population growth, and the rate of capital accumulation and technological progress, which is generally slow. As a result, most workers have to earn their living using their raw labour, with rudimentary tools and equipment, little education and training, and poor infrastructure. Labour productivity is low and there is widespread underemployment. This is the basic cause of persistent mass poverty in the LDCs.

The total labour force of the LDCs is estimated at 312 million people in 2000. Between 1990 and 2000, the labour force increased by 71 million, and between 2000 and 2010 it is expected to grow by a further 89 million to reach 401 million people. A large share of the increment in the total labour force between 2000 and 2010 (22 per cent), will occur in Bangladesh. However, all LDCs are experiencing a large growth in their labour force during the present decade. In 36 out of 50 LDCs for which data are available, the labour force is expected to increase by over 25 per cent.

The most important way in which labour has found productive work within LDCs over the last 25 years has been through agricultural land expansion. But this is becoming more and more circumscribed.

Firstly, as more and more arable land is being brought into cultivation in the LDCs, there is increasing dependence on fragile lands (such as arid regions, steep slopes and fragile soils). This is likely to become a major problem because extreme poverty can make it difficult for many households to use sustainable agricultural practices, and thus there are problems of land degradation and declining soil fertility. There are 31 LDCs in which over 30 per cent of the population live on fragile lands.

Secondly, land under crop cultivation per person engaged in agriculture is generally declining. For the LDCs as a group, the average size of the cultivated holding per economically active agriculturalist has fallen by 29 per cent over the last 40 years. Taking this ratio as a rough proxy of farm size, it is evident that in 32 out of the 50 LDCs, the average farm size

was under 1 hectare during 2000–2003, and for the LDCs as a group the average farm size was 0.69 hectares.

Thirdly, there are major inequalities in access to land resources and thus, even in apparently land-abundant countries where the land/labour ratio is apparently favourable, a significant share of the holdings are very small and a growing share of the population are virtually landless.

Against this background, urbanization is accelerating in the LDCs and a larger proportion of the population is seeking work outside agriculture. In 2000, 71 per cent of the labour force was engaged in agriculture and 75 per cent lived in rural areas. But the urbanization rate increased from 17 per cent in 1980 to 25 per cent in 2000, and the share of the population engaged in non-agricultural activities steadily increased from 21 per cent in 1980 to 29 per cent in 2000. These trends are widespread within the LDCs. In 1990, two thirds of the LDCs had less than one third of their population living in urban areas and less than one third of their economically active population engaged outside agriculture. But by 2010, less than one third of the LDCs will have this kind of economy and society.

Projections of the economically active population show that during 2000–2010, of the 89 million increase in that population, 49 million will be outside agriculture and 40 million within agriculture. This is a complete reversal of the pattern of the 1980s when 63 per cent of the increase in the economically active population was in agriculture. For the LDCs as a group it is the first decade in which the growth of the economically active population outside agriculture is expected to be greater than in agriculture. During the 1990s, a larger share of the growth of the economically active population was in agriculture.

The overall pattern of change for the LDCs as a group is strongly influenced by what is happening in Bangladesh. But in African LDCs, 46 per cent of the increase in the total economically active population is expected to be outside agriculture during 2000–2010 (as against 29 per cent in the 1980s) and in Asian LDCs other than Bangladesh, 45 per cent of the increase in the total economically active population is expected to be outside agriculture during the same period (as against 36 per cent in 1980s). The economically active population outside agriculture is

projected to grow faster than the economically active population within agriculture during the decade 2000–2010 in almost half the LDCs (24 out of 50 countries). These countries include Benin, Chad, the Central African Republic, the Democratic Republic of the Congo, Equatorial Guinea, Lesotho, Liberia, Mauritania, Sierra Leone, Sudan, Togo and Zambia in Africa; Bangladesh, Myanmar and Yemen in Asia; and Cape Verde, Kiribati, Maldives, Samoa, Sao Tome and Principe, Tuvalu and Vanuatu within the group of island LDCs. The break with past trends is also apparent in Haiti. In many of the other LDCs this break is projected to occur during the decade 2011–2020.

These estimates are, of course, projections which may not be realized. Also, they rely on international data and so national estimates may vary. However, they define the essential dimensions of the problem of poverty reduction in the LDCs. This requires productive labour absorption in agriculture and also in non-agricultural sectors. This will be impossible without the development of productive capacities through capital accumulation, technological progress and structural change.

Constraints on the development of productive capacities

National and international policies to develop productive capacities in the LDCs should prioritize identifying and relaxing key constraints on capital accumulation, technological progress and structural change. This should be done on a country-by-country basis and adapted to local realities. However, the Report focuses on three constraints on the development of productive capacities which are likely to be important in a number of LDCs:

- Physical infrastructure;
- Institutional weaknesses — firms, financial systems and knowledge systems;
- The demand constraint.

Physical infrastructure

Most of the LDCs have the lowest and poorest-quality stock of transport, telecommunications and energy infrastructure in the world. The infrastructure divide is particularly important with respect to energy. The "electricity divide" has not received as much attention as the digital divide. But it is at least as significant — indeed, probably more significant — for economic growth and poverty reduction. A major constraint on the adoption within LDCs of mature modern technologies already available in developed and other developing countries is the low level of technological congruence between the LDCs and other countries. The low level of electrification is a central aspect of this lack of technological congruence and thus contributes to the maintenance of the technological gap.

The infrastructure divide between the LDCs, other developing countries and OECD countries is not only wide but also widening. This is particularly apparent for road infrastructure. Measured by its mileage, the stock of roads per capita in the LDCs was actually lower in 1999 (the latest year for which comprehensive data are available) than in 1990. The percentage of the total roads which are paved in the LDCs also declined over the same period. The road stock per capita declined in both African and island LDCs, and the percentage of roads which are paved declined in African LDCs. In contrast, for the LDCs as a group, the number of fixed and mobile phone subscribers per 1,000 people increased eightfold between 1990 and 2002. But LDCs are still falling behind other developing countries and OECD countries, as there were more new subscribers in those last two country groups.

The low level and the poor quality of infrastructure stocks in the LDCs reflect poor maintenance of existing facilities and underinvestment in new facilities. This reflects declining public investment, the shift of ODA away from economic infrastructure towards social sectors, and limits to the interest of private investors in physical infrastructure in the LDCs. In real terms, ODA commitments for economic infrastructure declined by 51 per cent between 1992 and 2003. The decline in ODA committed to economic infrastructure was particularly marked in African LDCs. During the 1990s, there was an increase in private sector investment in energy and telecommunications. But private capital flows to transport have been

much lower and mainly concentrated in Mozambique, where they have been associated with cross-border corridor development projects.

Closing the physical infrastructure divide between LDCs and other developing countries, one of the quantitative targets of the Brussels Programme of Action for the LDCs, will require increased public investment and a reversal of the downward trend in aid for economic infrastructure which a number of LDCs, particularly in Africa, have experienced in the period 1990–2003. Improved physical infrastructure can play an important role in reducing the cost and time factors with which exporters have to contend in international trade transactions. However, infrastructure investment should not only focus on investment in trade-related infrastructure. Rather, there is rather a need for a joined-up approach to infrastructure development which includes: (i) rural infrastructure and district-level links between rural areas and small towns; (ii) large-scale national infrastructure (such as trunk roads, transmission lines and port facilities); and (iii) cross-border regional infrastructure. Increased public investment in the first is important for agricultural productivity growth and the development of a market economy in rural areas, as well as the creation of rural non-farm employment. Increased public investment in the second is important for diversification and structural change, as well as international trade integration. Increased public investment in the third is important for regional integration.

Particular efforts should be made to promote electrification and to close the electricity divide between LDCs and other developing countries. Most modern technologies require electricity, and the current low levels of access to electricity increase costs for firms, reducing their available funds for investment, and are a basic source of the technological incongruence between the LDCs and the rest of the world which is hampering the acquisition of technologies. This Report also shows that access to electricity affects the composition of exports in developing countries, and that differences in the degree of diversification into manufactures exports are partly related to the degree of electrification.

Institutional weaknesses

There is now increasing emphasis on the importance of institutions for economic growth and poverty reduction. But the major focus is on State capacities and good governance. It is clear that State capacities are vital for effective formulation and implementation of policies, and good governance is certainly necessary. However, there is an equal need to focus on the nature of the private sector and the institutions within which entrepreneurship is embedded. From this perspective, the Report shows that most LDCs have serious institutional weaknesses with regard to their firms, financial systems and knowledge systems.

Firstly, the size distribution of enterprises within LDCs is generally characterized by a "missing middle" in which a multitude of informal micro-enterprises coexist with a few large firms, and there is weak development of formal sector SMEs, particularly medium-sized domestic firms. There are weak linkages between the large firms and other enterprises, and the life cycle of enterprises is stunted. Few informal micro-enterprises become formal sector enterprises. Moreover, small firms are often unable to grow even when they are efficient. There is also wide heterogeneity in firm performance, although it is often found that the large firms tend to be more productive than the small firms with regard to most productivity indicators.

Secondly, and closely related to the phenomenon of the "missing middle", both the domestic financial systems and the domestic knowledge systems are dualistic. The financial markets are characterized by an informal segment (including transactions between friends and relatives or small-scale group arrangements, as well as transactions conducted by moneylenders, traders and landlords), as well as by formal banks. The domestic knowledge system includes a modern knowledge system alongside a traditional knowledge system. Different types of enterprises are embedded within these different systems.

Thirdly, the domestic financial systems have large liquid reserves, but as a ratio of GDP, domestic credit loaned to the private sector is four times lower than in low- and middle-income countries (15 per cent as against 60 per cent). Moreover, it has declined in the aftermath of financial

liberalization in many LDCs, particularly in African LDCs. During the same period, interest rate spreads have increased in LDCs, and the level of monetization has actually declined in African LDCs. Financial liberalization has simply failed to promote productive investment, as reflected in the poor delivery of credit to the private sector and to SMEs in particular. Banks are partly constrained because of the weak capacity of local entrepreneurs to formulate acceptable business plans and also because of weak contract enforcement. But at the same time, it is clear that the banks are very risk-averse and prefer to do business in the very safe areas of government bonds.

Fourthly, modern knowledge systems are vital for international competitiveness, but they are fragmented. Specialized creators of knowledge, such as research institutions, are not responsive to the demands of users. Evidence on the use of international standards within LDCs also suggests that there is a particular problem in terms of the extent to which the domestic knowledge systems are outward-looking and able to keep up with ever-rising international standards.

The development of productive capacities depends on the ability of an economy to create enterprises with a high propensity to invest, learn and innovate. SMEs are certainly important as they tend to use local inputs and thus are the agents that link local primary and manufacturing activities. They also provide employment for the local population. But an exclusive focus on SMEs is based on a static view of the development process. From a dynamic efficiency perspective, large-size firms are in a better position to generate the resources to achieve higher rates of capital formation, innovation, scale economies and the accompanying learning effects. Fostering linkages between large firms and SMEs is an important demand-side measure to complement the supply-side measures for SME development. Moreover, such inter-firm linkages can also facilitate knowledge transfers, technology transfer and technological upgrading. This suggests the need for an alternative policy framework based on supporting firm growth and expansion, the promotion of linkages between SMEs and large firms, the development of subcontracting relations, and the promotion of clustering and spatial agglomeration.

Overcoming bottlenecks in financing for the private sector should be a critical priority for policymakers in the LDCs. Without access to capital by the private sector, the potential for development of productive capacities cannot be achieved.

The importance of improving the financial systems in the LDCs is indeed widely recognized. However, new sources of financing urgently need to be identified and lessons may be drawn from the more successful cases in countries with deeper financial systems that are more responsive to the needs of the private sector. Historical experience suggests that a bank-based system is important at low levels of development. Possible financial institutions include the following:

- Loan guarantee schemes between the public and the private sector to facilitate access to bank credit for SMEs and large enterprises investing in technical change;
- Public development banks, particularly to create long-term financing;
- Value-chain lending in which lending to enterprises along a value-chain is coordinated;
- Innovative market-based financial instruments.

Knowledge systems are as important as financial systems in the development of productive capacities. Thus, improving domestic knowledge systems should complement efforts to improve the domestic financial systems. This involves not simply setting up special bodies oriented to creating knowledge which could be applied in production (such as research centres), but also creating bridging institutions with users and promoting linkages amongst the latter. For most LDCs the three most important sources for building their domestic knowledge base are education, foreign technology imports (through foreign licensing, FDI, turnkey plants and capital goods imports) and the mobility of experienced technical personnel. These are more important than seeking to increase levels of basic R&D. Investing in all levels of education, especially in technical skills and the building up of technological capabilities, is particularly important given the currently low levels of schooling which are found in most LDCs. Weak human resources make technology absorption difficult and slow down the technology catch-up process.

LDCs need to develop well-designed and coherent national technology learning strategies to increase access to technology and improve the effectiveness of imported technology, and to benefit from linking to global knowledge. There are major opportunities for blending modern and traditional knowledge in the areas of health and agriculture.

Demand constraints

The development of productive capacities cannot be achieved without addressing demand-side constraints as well as supply-side constraints. Yet demand as a source of growth has been generally neglected. Policies, and particularly aid inflows, which seek to engineer a supply-side fix for the weak productive capacities in the LDCs, without due attention to the dynamics of demand, are likely to fail. Inclusive development and poverty reduction require a development strategy which pays attention to the dynamics of domestic demand as well as external markets.

Evidence for a small but varied sample of LDCs shows that expansion of domestic demand has contributed most to their economic growth. Because domestic demand is such a large demand-side source of economic growth, its weak growth is a major constraint on the development of productive capacities in most LDCs. Sluggish domestic demand, which is associated with generalized and persistent poverty, is a central deficiency of the investment climate in the LDCs.

Because the share of agriculture in GDP and total employment is high in most LDCs, trends in domestic demand are closely related to what happens in the agricultural sector and also the nature of the linkages between agriculture and the rest of the economy. In this regard, the demand linkage effects of agricultural growth constitute an important growth and poverty reduction mechanism. In Bangladesh, it is possible to observe a virtuous circle in which demand stimulus from agricultural growth generates investment, entrepreneurship and employment in non-agricultural activities, particularly non-tradables. This virtuous circle is likely to be relevant in many LDCs and at the heart of efforts to create a more inclusive process of development which supports sustainable poverty reduction. Without the stimulus of domestic demand for non-

tradables, it is difficult to envisage the productive absorption of labour outside agriculture. However, the effectiveness of this linkage dynamic depends on income distribution.

Although domestic demand makes a critical contribution to economic growth in the LDCs, exports also matter. There are various supply-side reasons for this. But exports also matter because economic growth and the full utilization of productive capacities are constrained through the balance of payments. Each component of demand has an import content which is essential for the continuation of ongoing economic activities and their expansion, and countries need foreign exchange to pay for imports. Analysis of the LDCs within this framework shows that export growth has made a positive contribution. But its contribution to relaxing the balance-of-payments constraint has been seriously reduced by declining terms of trade and currency depreciation. It is also clear that capital inflows and transfers have played an important role in the LDCs in alleviating the balance-of-payments constraint.

This implies that upgrading the export structure of the LDCs should be a priority. There is a place here for new forms of industrial policy, which have been elaborated recently in developed countries, based on a mixed market-based model, with private entrepreneurship and government working closely together in order to create strategic complementarities between public and private sector investment, and the State not picking winners but rather helping the private sector to discover and exploit economic potentials.

In addressing the issue of developing productive capacities in the least developed countries, it is necessary to maintain a balance between the constraints and the opportunities of the present situation. The evidence in this Report on the low level of development of productive capacities in most LDCs and on the weakness of processes of capital

accumulation, technological progress and structural change is sobering. However, there are also major opportunities for rapid economic growth and substantial poverty reduction if constraints on the development of productive capacities can be relaxed in a systematic way, and underutilized productive resources and entrepreneurial capabilities can be harnessed for development. National Governments have the primary responsibility in this task. But both a favourable international enabling environment and enhanced international support for the LDCs are also necessary and can provide great benefits not simply for the LDCs but also for the world as a whole.

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